Journal of Accountancy

Volume 61 | Issue 1 Article 5

1-1936

Money and Bank Deposits

Harvey S. Chase

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Chase, Harvey S. (1936) "Money and Bank Deposits," *Journal of Accountancy*: Vol. 61: Iss. 1, Article 5.
Available at: https://egrove.olemiss.edu/jofa/vol61/iss1/5

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Money and Bank Deposits

By Harvey S. Chase

What is MONEY? The *Standard Dictionary* says: "Anything that serves as a common medium of exchange in trade, as coin or notes." The *Modern Encyclopædia* says: "Money consists of legally fixed units of a medium of exchange. A 'medium of exchange' is any commodity in terms of which the values of other commodities are expressed." The definition of money accepted by the majority of economists, money theorists and many bankers includes not only currency (coins and notes) but also "bank-deposits." Prof. G. D. H. Cole of Oxford in his book, *What Everybody Wants to Know about Money* (Knopf, 1933), after treating of coin and bank notes and concluding that both are money, then deals with cheques. He says: "A cheque differs radically from a bank note, though they are both in form promises to pay. A bank note is a banker's promise to pay; and if it is issued by a reputable bank it passes easily from hand to hand without necessarily being ever converted into any other kind of money." He then queries: "If we reject cheques from our definition of money, what are we to regard as the money which these cheques transfer from one person to another? This brings us to the question of bank deposits. Bank deposits are, in the most developed communities, by far the most important means of payment and those with the aid of which the largest and most important business transactions are habitually settled. It seems then that our definition of money must be wide enough to include bank deposits."

This conclusion is also accepted by Professor R. F. Harrod of Oxford, author of *International Economics*, who says: "The total amount of money in the community is found by adding together the amounts held by all individuals, corporations and institutions; it is equal to the total of coins and notes in circulation plus all the deposit balances at all the banks."

Similar quotations from students of finance, with hundreds of assertions that bank deposits are "money" might be quoted from well-known professional experts in America as well as Great Britain.

Dr. Ralph A. Young of the Wharton school of finance, in a volume published by the national industrial conference board

under the title *The New Monetary System of the United States* (August, 1934), says: "Treasury currency constitutes only a part of our domestic supply. Actually, it constitutes only a small fraction of the total effective monetary supply in the hands of the public for spending. The bulk of the effective supply is furnished by the commercial banks in the form of deposits subject to cheque." One more quotation may seem to clinch the argument. Hon. Reginald McKenna, chairman of the Midland Bank, Ltd., of London, is quoted as saying, "By far the larger part of our total money consists of bank deposits."

It would seem the height of temerity, in the face of such wide acceptance of "deposits" as money, even to suggest that there may be another answer—a negative one. Nevertheless, examining the matter from the point of view of a professional accountant familiar with banking methods and aware of the necessities of bank practices, I have become convinced after much study of both sides of this question that the statement "banks create money" is erroneous. Such a statement follows from the generally accepted first premise that "banks create credit" by allowing customers to have chequing accounts through "bank deposits." The second premise, "bank-deposits are money," leads logically to the conclusion, "banks create money."

It is advisable, I believe, to reconsider the question from the standpoint of reality: from the basic facts of bank practices and necessities. Those who accept the affirmative, "Bank-deposits are money" generally picture the banker, when granting a loan to a customer, as immediately setting up a credit to the customer on the bank's books, against which the customer may draw cheques and pay his creditors and employees with these cheques. In due time these cheques return to the bank which charges them against the deposit account set up "by a stroke of the banker's pen." Certain extremists, such as the proponents of social-credit and allied hypotheses, assert that these procedures prove that the banker created money when the credit-deposit was set up and that this was actually "creation" because "it arose from nothing."

To analyze this contention, consider what actually occurs when bankers make loans and set up "deposit-accounts" to the credit of their customers. Bank "A," we will say, after sufficient inquiry, accepts a customer's application for a loan of ten thousand dollars, due in three months. The bank takes the customer's

promissory note for that sum and enters on the bank's books a debit account for the note as an asset. In other words, the bank has bought the customer's note and must now pay for it. Consider two ways of paying for this purchase. First, suppose the customer desires cash for the full amount, less the discount. The bank (A) pays over the counter ten thousand dollars in currency, minus the interest for three months. Evidently in such a transaction no "deposit account" is set up. The bank has merely swapped one type of asset, cash, for another type of asset, promissory note. It has bought and paid for an earning asset.

Suppose, secondly, that after paying over the currency to the customer (X) the latter decides that it will suit his convenience to return this money to the bank and have it credited to a deposit account in his name on the books, against which he may draw cheques as he pleases. Evidently, in this second case, there is no "creation" of money when the banker's stroke of the pen sets up the deposit account for the customer. The bank paid out ten thousand dollars (omitting discount for simplicity) and gets the ten thousand back again. The banker's pen was busy but it did not create money.

Consider a third method, the usual one, namely: The bank takes the note as before and sets up the asset account for the note. The banker, however, does not pay the customer for the note then and there, but instead he sets up a deposit account for ten thousand dollars on his books as a credit to the customer. What does this action imply? The banker has bought the customer's note but he does not pay for it. Instead he gives a credit to the customer for the amount of the note. Evidently this credit account is a liability, a record of the bank's debt to the customer for the note it has purchased from him.

This, then, is what the "deposit account" means—a *debt* of the bank. How does the bank propose to pay this debt? It proposes to pay by honoring the customer's (X's) cheques, which the customer draws as he desires, up to the full amount of the debt. As each cheque reaches bank A, over the counter or from other banks, the amount is charged against the credit account of the customer and thereby reduces the bank's debt to the customer. Each cheque is cancelled by the bank and returned to the customer as evidence that the bank has received and charged it, leaving the balance of the debt still unpaid. Finally a last cheque wipes out this balance and the bank has then paid its debt in full.

The bank now owns the note free and clear and can collect the ten thousand at maturity.

The picture is not complete if we stop here, however, as social-credit and other propagandists do. There are extremely important actions which occur when each cheque reaches bank A. If some of these cheques are presented by employees of X who desire to cash them, the bank will pay the cheques in currency over the counter and its cash assets will be correspondingly reduced. This is clear. The bank has paid for these cheques, not in "thin air" or "creation from nothing," but in hard coin or legal tender bank notes, definitely diminishing its accumulated assets.

The majority of the customer's cheques, however, will reach bank A from other banks, B, C, D, etc., where X's creditors have deposited the cheques they received from him in payment of his debts to them. The banks (B, C, etc.) enter these cheques to their customers' credits and stand ready to pay for them over the counter in currency if called for. Through "clearing," all these cheques ultimately reach A and are paid by A through transfer of cash, or diminishment of credits, to B, C, etc. These settlements through clearing are just as real payments of the cheques, by A's actual assets, as if paid in cash over the counter. My readers must see that this is true. All the cheques drawn by X have to be paid for in good assets by bank A. There is no escape. Evidently the stroke of the banker's pen which set up the deposit-account to X in the beginning did not "create money." It created the record of a debt, due to X by the bank because of the bank's purchase of X's note.

It is plain to see that, so far as the giving of credit is concerned, the bank created no credit for X. On the contrary X allowed credit to the bank. Literally, he did so. He permitted the bank to take his note and add it to the bank's assets without giving him anything except a promise to pay for his cheques as drawn. The bank got X's note for ten thousand—a good asset—"for nothing" temporarily, but had to pay for it, cheque by cheque, in correspondingly good assets as these demands came in. The whole transaction is in accord with the first illustration given, where the bank surrendered ten thousand dollars of cash assets and received a like sum through X's note at three months. There was no "creation of money" in the first case, as is plainly evident. No more is there creation of money in this last case.

Assets have been exchanged for assets in both cases. No new money appeared in either case. The only difference is that in the first case the bank paid its debt immediately in cash, while in the last case it took its time about paying it or, rather, it took Mr. X's time—as his cheques were honored.

When banks must pay in good assets for every customer's cheque they honor, the allegation of "creation of money from nothing" is absurd, no matter what distinguished men support such an hypothesis. Such assertions are based upon ignorance of the necessities of banking practice or upon the failure to "think through" the actualities of that procedure.

Major Douglas of social credit asserts that banks buy securities for nothing. "Any normal type of bank," Major Douglas says in a recent magazine article, "acquires securities by exchanging a draft upon its own credit for the securities, thus increasing the money in the hands of the public by the amount paid and increasing its own assets by the securities acquired." He goes on, "It is quite fair to say that a financial institution in such a case acquires securities for nothing."

Securities, like promissory notes, are records of debts. Securities are generally long-time debts while notes are usually short-time debts. When banks (federal reserve banks, for instance) purchase securities in the open market they may not pay for them immediately over the counter but set up liability accounts on their books to the credit of the person, firm or corporation from whom they purchased the security. This "credit"—like that arising from the purchase of a customer's note—is not creation of money but is merely a record of debt to the seller or to the government if bonds or short-time paper are purchased directly from the government. Hundreds of millions of dollars of such securities are purchased by banks, carrying with them book records of increased assets (values of the securities) and correspondingly increased liabilities—the deposit accounts—in these banks.

There should be no distinction in theory or practice between open-market operations and promissory-note operations—merely differences in the kinds of promises to pay. The effects on bank deposits are identical; there is no creation of money in either case and the allegations by proponents of fantastic hypotheses are as untrue in one case as in the other.

Bank deposits are being built up in enormous quantities today through purchase by banks of our government's securities—

long and short terms—and corresponding vast issues of cheques are flooding the mails and clearing associations. These tangible cheques act temporarily as media of exchange. They pass from bank to bank and sometimes from hand to hand like currency, but Professor Cole says they are not money and in the same breath he says the intangible book records of bank debts—"deposit accounts"—are money. If cheques have not all the qualities of bank notes and other "currency," they certainly have more of these qualities than have the mere book records of banks' debts. They at least are tangible like currency; they are "media of exchange" certainly; they pass from one to another person or bank and they are promises to pay, as bank notes or government currencies are.

"Bank deposits," on the contrary, have none of these qualities of money. They are intangible; they do not pass from hand to hand; they are merely book records representing the increases and decreases of banks' debts. If cheques can not be considered "money," as Professor Cole declares, then certainly there is no logic in claiming bank deposits to be money.

It is clear from these considerations that any statement to the effect that banks "create money" by writing up "deposits" is untrue. The process is not one of creation but is one of exchange. It is subject to definite limits and the deposits which appear are only potential money claims. Indeed, they become actual increases of purchasing power only when the initiative in the growth of assets (notes), and of deposits correspondingly, comes not from the banks but from customers who desire to make immediate use of the convenience and safety of chequing-accounts at the banks.

The only valid excuse for considering the total of bank deposits to be money, as is so habitually but illogically done by many of our leading economists and statisticians, arises from the fact that as there is no possible means of determining what values of cheques (drawn against deposit accounts) are afloat in the mails at any moment relating to any bank, the only figures which it is possible to use are the total cheques "cleared" during the day, with the total of all balances of deposit accounts at the end of the business day.

While such figures give only approximate indications of the total cheques which all the John Joneses and the Bill Smiths have drawn that day—which constitute the real media of exchange—

yet the total of unpaid balances of deposits compared one day with another does give some indication of the so-called "bank money" afloat, and from such comparisons reasonably fair estimates may be made on which to base decisions as to whether business as a whole is increasing or decreasing. Thus it has come to be assumed that bank-deposit balances represent purchasing power and may be considered "credit money" or "contingent money" or "bank currency" or, finally, plain money.

Perhaps the simplest way to clarify these rather complicated questions to the average intelligent but uninformed person is to compare "bank deposits" with everyday claims for wages and salaries for work done, services rendered. The reader, whatever his vocation, works for an expected—usually an agreed upon—compensation. All through the week or month he works daily at his particular stunt. He accumulates a wage-claim against his employer. This wage-claim is a debt of his employer to him. It is not money. The money in the case is in his employer's pockets or bank account and all the worker has is a claim against this money. In due time his wages are paid in currency (or by cheque, good for currency) and he has the money. The claim, while it was a debt the employer owed him, was not money.

Just so, the bank-deposit is not money. It is a claim, like the wages earned, against the money (liquid assets) of the bank. The bank pays the claim by accepting the customer's cheques and paying for them in currency or credit to other banks or cash over the counter.

The conditions are identical. The wage-claim is not money; no one will assert that it is money by itself, but our economists and illogical bankers say the claim of the deposit account is money. The error is evident. The money is in the bank's vaults and reserves—liquid assets. The claims against it, represented by deposit-account balances, are not "purchasing power." The assets are the only purchasing power, both in the case of the wages-claims and of the deposits-claims.

One of the most voluminous writers of the day in a recent magazine article made this statement: "If a person has a million dollars and loans it, he does not have the million dollars any more, tho' he has the borrower's note, but if a bank has a million dollars and loans it, the bank has two million dollars—the million it had at first and the million created by the 'deposit' set up by the

loan." Two millions for one. Grand! Let's all go into the banking business.

Absurd as this statement appears in cold type, it is typical of the misunderstandings prevalent in all quarters which depend upon alleged expert economists' assertions, such as "bank deposits are money."

The writer in question was misled by a lack of visualization of accounting requirements. He thought of the million assets of the bank as one item and of the "created" deposit from the loan as a second item, failing to realize that while the first is a reality, a plus item, the second is a debt, a minus item. If added together they cancel each other and there is nothing left—not "two millions" for one. What remains on the bank's books is only the value of the note or security, an asset of one million dollars—the cash and the deposit are both wiped out. This is what occurs in fact, though not immediately in practice. The bank's cash assets are reduced by every customer's cheque honored and the customer's deposit-account is similarly reduced by each of such cheques until finally both accounts disappear simultaneously.

Conclusions

1. Bank deposits are not credits granted to customers by banks, but are records of the debts of the banks to their customers.

2. Bank deposits are intangible and in themselves have none of the characteristics of money except the claim that they are, as Professor Cole puts it, "by far the most important means of payment."

3. What are the tangible "means of payment" identified with bank deposits?—Cheques, evidently.

4. What gives cheques their power as "means of payment"? Is it because they are drawn against a bank deposit, as such—a debt record of the bank? Or is it because the drawer of the cheque has assumed thereby, with the sanction of the bank, a status of creditor to the bank; in command of the bank's liquid assets up to an agreed limit?

5. It is this right to call for liquid assets of the bank to be paid over to his own creditors that gives the "means of payment" power to cheques. Bank deposits, when liquid assets of the bank are gone, have no power of payment. They stand on the books as they did before the run or the scandal which wiped out the assets, but they are valueless. The bank's liquid assets are

the true "means of payment," not the records of debts—the bank deposits.

6. It is because this fundamental fact is not recognized or is glossed over by writers on banking theory that amateurs like Major Douglas, Frederick Soddy, Guy Mallon and countless others have misunderstood the actual relationships and have laid emphasis in the wrong place, by declaring that the writing of a bank deposit "creates money." The fact is that the money is already in the bank's assets and the "deposit" is merely the bank's acknowledgment that the customer has the right to use these liquid assets for his own purposes by means of his drafts (cheques) against the bank.

7. It is for this reason—the right to use the bank's assets as his own—that the customer is willing to pay interest upon his note, sold to the bank but not yet paid for. The great advantage to the customer of using the bank's funds and its financial standing for his own purposes, up to the limit set by the note, fully justifies the payment of interest as a service charge for these advantages. The bank gives quid pro quo—not "something from nothing."

Of course the service charge (the interest) may be too high for the service rendered. The customer must decide that—if free to do so. If not free to do so, the excess may be theoretically considered usury, and something for nothing begins to appear.

8. These conclusions, which arose from a critical study of "social-credit" early in 1935, are primarily intended to make evident the erroneous nature of the assertions of Major C. H. Douglas and his supporters. Misled by the plausible and, doubtless, sincere beliefs of the proponents, many thousands of untrained individuals in England, Australia, New Zealand, Canada and the United States are giving wider credence daily to these mistaken ideas—such as I have quoted. It is necessary, therefore, in the interest of truth and of correct understanding of banking theory and practice, that these erroneous ideas be combatted.

9. It is, of course, true that bank-deposits when viewed from the reversed position of the borrower rather than from that of the banker, i.e. as *assets* in the private books of the borrower instead of as liabilities on the books of the bank, may with some measure of verity be considered prospective "means of payment," as claims against the actual assets of the bank. For the borrower, who must pay his debts to his creditors, the ability to draw upon the bank's assets by means of the cheque system of the bank, justi-

fies him generally in considering his deposit balance at the bank as his best "means of payment." With sound banks and in normal times he may believe his bank account to be, perhaps, his most assured asset, but in abnormal times, such as the world has been experiencing, this dependence upon his bank balance as a secure and most convenient asset is upset; his assurance that this account as *money* is lost and he demands bank-notes, government currency, or gold in place of such "contingent money." When the emergency arrives, his belief in the money value of bank deposits fades away and the uncertain nature of "deposits" as *money* becomes vividly apparent.

10. The crux of these opposing assertions regarding what should be included in the term "money" is this: (1) The economic definition of money is; A commodity which is generally accepted by business men of all classes and nations as "a common medium of exchange." This is the original and primary meaning of "money." (2) The juristic definition of money is; A generally accepted "means of payment." This definition of money is the one which has been adopted, consciously or unconsciously, by those who assert that bank-deposits, bank-notes, cheques and other "money-substitutes" should be included in the term money. From a juristic point of view money is primarily "a means of payment," but only because money is accepted as a common medium of exchange. The juristic view is secondary; the economic view is primary.

Professor Ludwig von Mises, of the university of Vienna, the leading and most profound economist on the continent of Europe, says in regard to the juristic view: "The concept of money as a creature of law and the state is clearly untenable. It is not justified by a single phenomenon of the market. To ascribe to the state the power of dictating the laws of exchange is to ignore the fundamental principles of money-using society. From the legal point of view money is the common medium of payment or debt-settlement, but money becomes a medium of payment only by virtue of being the medium of exchange. Only because of this does the law make it the medium for fulfilling obligations not contracted in terms of money, but whose literal fulfillment is for some reason impossible. . . . It does not come within the scope of the legislator or jurist to define the economic concept of money."

So the confusion and contention simmer down to a logical choice between definitions 1 and 2. The first has come down from remote antiquity and is primary in economic science. The

second is a relatively recent adoption by modern schools of economists and bankers, who advocate the idea of money as a "thing of thought" only, which acts by judicial interpretation as a "means of payment" and therefore that all accepted means of payment must be money.

To bewildered students I advise an intensive study of von Mises' recently translated book (English) *The Theory of Money and Credit.*